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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Sixth Annual Washington Roundtable

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Institutional Investor Institute

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Most recoveries follow a typical pattern, but many of them also have their special features. In the monetary area, one of the special features of the present expansion has been the very modest increase in the money supply with which it has been financed. Since the first quarter of 1975, which is the first year of the expansion, M_1 (currency and demand deposits) has risen by about 5 per cent,^{1/} M_2 (M_1 plus savings and time deposits in banks excluding large CD's) by about 9-1/2 per cent and M_3 (M_2 plus time and savings deposits in

^{1/} All data for the monetary aggregates -- M_1 , M_2 , and M_3 -- are as of April 30, 1976, with March 1976 being the last month for which complete data are available.

thrift institutions) by 12 per cent. Since GNP in nominal terms rose at an average rate of 12.7 per cent during the four quarters ending March 1976, the seeming disproportion between the behavior of money demand and of GNP is notable. Yet this result has been achieved not, as one might suppose, in a context of rapidly rising interest rates. On the contrary, interest rates now are lower than at the beginning of the expansion in April 1975. Nor has the moderation in the growth of the money supply been accomplished at the cost of sluggishness in the real sector. The average rate of real gain is broadly in line with the average of past expansions.

The rate of M_1 growth, indeed, has been far below what standard models would have predicted. A standard money demand function shows an overprediction of M_1 , compared to what was actually realized, of \$19 billion over the last seven quarters. It was in the light of such hypothetical money supply requirements that many observers called for a more rapid growth of the aggregates during the initial phase of the expansion. Their argument was often buttressed by reference to the large excess capacity then prevailing in the economy. Some observers also called for massive "front-loading" of the money supply, in the form of a rapid increase in the aggregates during a short period, to be followed by more moderate growth rates thereafter.

A variety of explanations have been adduced for the surprisingly moderate demand for M_1 , given the vigorous expansion of nominal GNP and the moderate decline of interest rates. One has been a historical tendency of the velocity of M_1 to accelerate pronouncedly during the early phases of an expansion. The average relationship between M_1 on one side and income and interest rates on the other, as derived by econometric methods, averages away some of the differences in behavior during early and late phases of expansion. Past experience of very high interest rates may have awakened balance holders to the gains obtainable from more economical balance management, and these new methods seem to have been carried over into periods of lower rates. Various regulatory actions facilitating the use of savings deposits for money payments, such as telephone transfers between demand and savings accounts and authorization for businesses to carry savings deposits of up to \$150,000, have reduced the demand for M_1 . The demand for M_2 and M_3 has been less affected.

The Federal Reserve's long-run and short-run growth ranges for the monetary aggregates have been set with these factors in mind. The long-run growth range for M_1 , originally 5 - 7-1/2 and now standing at 4-1/2 - 7 per cent, as well as the M_2 range of originally 8-1/2 - 10-1/2 and now 7-1/2 - 10 per cent, and the M_3 range of originally 10-12 and now 9-12 per cent, have taken into account the need to bring down the rate of money growth from the high levels

associated with double-digit inflation if in the future inflation is to be brought down further from what I regard as an unacceptable level. These ranges have also taken into account the tendency of velocity to accelerate strongly during early phases of an expansion.

Over the period during which long-term ranges have been announced in accordance with Concurrent Resolution 133 (five times), these ranges have changed only very moderately, in a downward direction. The succession of ranges nevertheless has reflected more variability in money growth than appears at first glance. The base from which one-year rates of growth have been projected has shifted from quarter to quarter by the amount of the realized growth in the quarterly average each quarter. In other words, these successive ranges have been computed, not from the previous base, or from the previous base adjusted forward along the midpoint growth path of the previous range, but from the level of the quarterly averages attained in the previous quarter. A "base drift" has occurred to the extent that actual quarterly average growth has differed from growth along that midpoint growth path. For example, in the case of a 5 - 7-1/2 per cent range, the midpoint growth path would have meant 6-1/4 per cent growth per year, or about 1.53 per cent compounded quarterly. If money were to show no growth in any one quarter, a downward base drift of about 1.51 per cent would have occurred for the ranges of the following quarter. (I have appended data on the long-term growth ranges and their interrelations with the growth actually experienced.)

Various critics have argued that this base drift for the calculation of growth rates causes the actual rates of growth over several quarters to differ from the specified range even if the range were maintained unchanged from quarter to quarter. The procedure, it has been charged, makes the actual movement of the aggregates a random walk.

In the light of the historical record, this criticism lacks substance. Base drift over successive quarters in the last year has been relatively small. Moreover, such quarterly moves have been largely mutually offsetting. From the first to the second quarter and from the second to the third quarter of 1975, growth rates were on the high side, and the ranges set in those two quarters accordingly represent upward shifts of the long-run paths. But in the fourth quarter of last year, growth rates were on the low side and the ranges set in that quarter represent a downward shift in the growth paths of the three aggregates. The bases for the ranges set for the year beginning with the first quarter 1976 have returned approximately to those implied by the midpoints of the ranges specified a year ago. The latest ranges were announced by Chairman Burns before the Senate Committee on Banking, Housing and Urban Affairs on May 3. As a practical matter, therefore, base drift has not materially affected the movement of the aggregates. Over the last four quarters, M_1 grew at the low end of its original growth range, M_2 at the midpoint of its original range, and M_3 at the top end of its range.

If deviations from the ranges were to become large, some cognizance of that fact would, of course, have to be taken in the setting of new ranges. The FOMC does, of course, set new ranges in the light of the recent growth of the aggregates in addition to changes in the economy and the outlook that have occurred meanwhile.

Techniques could be visualized that would compensate for base drift above or below the midpoints of earlier ranges. Growth ranges could be modified in such a manner as to get back on the original track at some specified point in time, assuming that this track had remained appropriate in the light of the economic outlook. Alternatively, in addition to stating the new ranges of growth on the new base, those same ranges could be recomputed in terms of the old base. Either method, however, would tend to be confusing to many members of the public and would add little to deliberations of the FOMC, which in any event has access to these and other calculations.

Moderate base drift in any event has little meaning, given the looseness of the relation of the monetary aggregates to the ultimate objectives -- GNP, employment, and price stability. It is these ultimate objectives, of course, which primarily concern the monetary policymaker in the setting of long-run growth ranges.

A problem that concerns me more has been raised by the wider than expected spread between the actual growth rates of M_1 on one side and M_2 and M_3 on the other. The growth ranges allow, of course, for substantially different growth paths for each of the aggregates. M_1 may come in low, as it did over the last year, and M_3 may come in high as it did, and yet all three aggregates may be within or close to their respective ranges. But the midpoints of the ranges suggest that there is some expected difference in the three growth rates that under neutral conditions would remain reasonably constant over some period of time. Conditions evidently have been far from neutral. In particular this has meant increasing uncertainty about the reliability of M_1 as a target. Special factors affecting M_1 evidently have been operative on the downside. Meanwhile, M_2 and M_3 have been subject to factors operating on the upside, especially a tendency toward reintermediation at a time of low interest rates for money market instruments.

The FOMC has responded to mounting instability in the behavior of the aggregates in several ways. In a recent directive, it decided to place about equal weight on M_1 and M_2 , whereas previously greater weight frequently had been attached to M_1 . Furthermore, the FOMC has responded by widening the two-months ranges for all the aggregates, but particularly for M_1 . In the record of

policy actions for the February 18 FOMC meeting, for instance, the M_1 tolerance range for the February-March period was specified at an annual rate of 5-9 per cent, or 4 percentage points, contrasted with an average range of 3 percentage points found in past FOMC actions. For M_2 the range was 9-13 per cent, the 4 percentage point spread here contrasting with a frequently employed spread of 3 per cent. Also, the FOMC has at times couched its directive to the Federal Reserve Bank of New York in "money market" rather than "aggregates" terms, making "maintenance of prevailing bank reserve and money market conditions over the period immediately ahead" the primary instruction to the Manager while relegating the aggregates to a proviso clause that subjects the stated objective to the condition "provided that monetary aggregates appear to be growing at about the rates currently expected." Such a money market directive was issued at the March 16 FOMC meeting.

A well known rule of thumb of monetary policy says that when there are disturbances on the side of the real sector, monetary policy should focus on the aggregates and allow interest rates to move up or down in order to counter the disturbance. Conversely, when there are disturbances on the monetary side, monetary policy should focus on interest rates in order to avoid transmitting these disturbances to the real sector. What we have seen of late

clearly has been a disturbance on the monetary side -- the less predictable demand for M_1 . To keep M_1 on a fixed growth path under those conditions would mean wide variations in interest rates, in a downward direction in case of an unexpected shortfall in the demand for M_1 . The FOMC has taken account of this by giving somewhat greater emphasis to M_2 or money market conditions and by widening the two-months ranges especially that for M_1 , as noted earlier. The effect of the latter move is to reduce the change in the Federal funds rate to be sought by the Open Market Desk in response to a given deviation of M_1 from the midpoint of the specified range. Still another technique would be a narrowing of the funds rate range within which the Desk is to operate.

Turning once more to the longer run, I would like to draw your attention to the small but significant lowering of the one-year ranges for M_1 and M_2 . We have, of course, a long way to go until noninflationary rates of money growth are attained. But a beginning must be made. Inflation will not come down for long if the Federal Reserve allows growth rates of the aggregates to move in a procyclical direction. Lower rates of inflation, we have learned from experience, offer the only hope for a lasting reduction in unemployment and the achievement of stable prosperity.

TABLE 1.--Federal Reserve Growth Range Targets for M₁ Money Stock and Results to 1976:Q1

Announcement date	May 1, 1975 ^{1/}	July 24, 1975		Nov. 1, 1975		Feb. 2, 1976		May 3, 1976		Actual M ₁ stock <u>2/</u>	
Growth rate ranges (annual rates)	5% to 7.5%	5% to 7.5%		5% to 7.5%		4.5% to 7.5%		4.5% to 7%		(quarterly average, s.a.)	
Base date	March 1975	1975:Q2		1975:Q3		1975:Q4		1976:Q1			
<u>1975</u>											
Q1	284.1 ^{3/}									282.6	
Q2	286.4	287.5	287.8							287.8	
Q3	290.0	292.8	291.2	293.1	292.9					292.9	
Q4	293.6	298.1	294.8	298.2	296.5	298.2	294.7			294.7	
<u>1976</u>											
Q1	297.2	303.6	298.4	303.8	300.2	303.7	298.0	300.1	296.8		296.8
Q2	300.8 ^{(298.4)^{4/}}	309.1	302.1	309.4	303.8	309.2	301.2	305.6	300.1	301.9	
Q3	304.6	314.8	305.8	315.0	307.6	314.9	304.6	311.1	303.4	307.0	
Q4	308.3	320.5	309.6	320.8	311.4	320.6	307.9	316.8	306.7	312.3	
<u>1977</u>											
Q1	312.1	326.4	313.4	326.6	315.2	326.5	311.3	322.6	310.1	317.6	

Notes to Tables 1-3 follow Table 3.

TABLE 2.--Federal Reserve Growth Range Targets for M₂ Money Stock and Results to 1976:Q1

Announcement date	May 1, 1975 ^{1/}	July 24, 1975	Nov. 1, 1975	Feb. 2, 1976	May 3, 1976	Actual M ₂ stock <u>2/</u>				
Growth rate ranges (annual rates)	8.5% to 10.5%	8.5% to 10.5%	7.5% to 10.5%	7.5% to 10.5%	7.5% to 10%	(quarterly average, s.a.)				
Base date	March 1975	1975:Q2	1975:Q3	1975:Q4	1976:Q1					
<u>1975</u>										
Q1	623.0 ^{3/}					618.6				
Q2	631.5	633.4	634.3			634.3				
Q3	644.5	649.4	647.4	650.3	650.3	650.3				
Q4	657.8	665.9	660.7	666.8	662.2	666.8	660.2	660.2		
<u>1976</u>										
Q1	671.4	682.7	674.3	683.7	674.3	683.6	672.2	676.9	675.9	675.9
Q2	685.2	699.9 ^{4/}	688.2	700.9	686.6	700.9	684.5	694.0	688.2	692.2
Q3	699.3	717.6	702.4	718.7	699.1	718.7	697.0	711.6	700.8	708.9
Q4	713.7	735.7	716.9	736.8	711.8	736.8	709.7	729.6	713.6	726.0
<u>1977</u>										
Q1	728.4	754.3	731.7	755.5	724.8	755.5	722.7	748.1	726.6	743.5

Notes to Tables 1-3 follow Table 3.

TABLE 3.--Federal Reserve Growth Range Targets for M₃ Money Stock and Results to 1976:Q1

Announcement date	May 1, 1975 ^{1/}		July 24, 1975		Nov. 1, 1975		Feb. 2, 1976		May 3, 1976		Actual M ₃ stock ^{2/}
Growth rate ranges (annual rates)	10%	to 12%	10%	to 12%	9%	to 12%	9%	to 12%	9%	to 12%	(quarterly average, s.a.)
Base date	March 1975		1975:Q2		1975:Q3		1975:Q4		1976:Q1		
<u>1975</u>											
Q1	1003.7 ^{3/}										994.8
Q2	1019.8	1022.8	1026.1								1026.1
Q3	1044.3	1052.2	1050.8	1055.6	1060.1						1060.1
Q4	1069.5	1082.5	1076.2	1085.9	1083.2	1090.6	1084.5				1084.5
<u>1976</u>											
Q1	1095.3	1113.6	1102.1	1117.1	1106.8	1121.9	1108.1	1115.7	1114.5		
Q2	1121.7 1125.4 ^{4/}	1145.6	1128.6	1149.2	1131.0	1154.2	1132.3	1147.7	1138.8	1146.5	
Q3	1148.7	1178.5	1155.8	1182.3	1155.6	1187.3	1157.0	1180.7	1163.6	1179.5	
Q4	1176.4	1212.4	1183.7	1216.3	1180.8	1221.4	1182.2	1214.7	1189.0	1213.4	
<u>1977</u>											
Q1	1204.8	1247.2	1212.2	1251.2	1206.5	1256.6	1208.0	1249.6	1214.9	1248.3	

Notes to Tables 1-3 follow Table 3.

Notes to Tables 1-3

Each of the five sets of growth ranges so far announced by the Federal Reserve for M_1-M_3 has presented such ranges for a one-year horizon measured from successive base dates. To provide a common terminal point, Tables 1-3 extend the "cones" represented by each set of growth rates to 1977-Q1. The dashed lines in each column of the tables show the horizon to which the ranges given in those columns originally related.

1/ The first set of growth ranges for M_1-M_3 presented by the Federal Reserve was stated in terms of a March 1975 base and growth to March 1976. The four subsequent sets of ranges were stated in terms of a quarterly average base. For visual comparability, the "cones" implied by the first set of ranges have been restated to quarterly average terms.

2/ To obtain a consistent historical series, the "actual" money stock for each base period is given according to recent seasonally adjusted data. The base level shown for each period may therefore differ slightly from the preliminary base available at the time each set of ranges was announced.

3/ March 1975 data.

4/ March 1976 data (preliminary).